DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 01-0127; 01-0128
Indiana Corporate Income Tax
For the Years 1996 and 1997

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ISSUES

I. **Applicability of the Throw-Back Rule** – Adjusted Gross Income Tax.

Authority: 15 U.S.C.S. § 381; IC 6-3-2-2; IC 6-3-2-2(e); IC 6-3-2-2(n); IC 6-3-2-2(n)(1); Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447 (1992); 45 IAC 3.1-1-53(5); 45 IAC 3.1-1-64.

Taxpayer argues that the Department of Revenue (Department) erred when it determined that the income received from sales of auto parts to its Illinois customer was subject to Indiana adjusted gross income tax.

II. **Management Fees and Royalty Payments as Indiana Source Income** – Adjusted Gross Income Tax.

Authority: IC 6-3-2-1; IC 6-3-2-2(a); 45 IAC 3.1-1-38; 45 IAC 3.1-1-38(4); 45 IAC 3.1-1-55.

Taxpayer argues that as the out-of-state parent company, money it received in the form of management fees and royalties from its Indiana manufacturing division was not subject to the state's adjusted gross income tax.

STATEMENT OF FACTS

Taxpayers are in the business of manufacturing and selling original equipment auto parts. There are two separate but related entities involved in this protest. The first entity is the out-of-state parent company; the second entity is the manufacturing division which operates a manufacturing facility in Indiana.

The Department of Revenue conducted an audit review of taxpayers' 1996 and 1997 business records and tax returns concluding that both taxpayers owed additional Indiana corporate income tax. Taxpayer manufacturing division (located in Indiana) argues that money received from the sale of its auto parts to an Illinois auto manufacturer should not have been "thrown back" to Indiana. Taxpayer parent company (located in Michigan) argues that money received from

taxpayer manufacturing division in the form of management fees and royalties was not subject to Indiana's corporate income tax.

Taxpayers both challenged the audit's conclusions and the assessment of additional income tax. They submitted a protest to that effect, an administrative hearing was conducted during which taxpayers explained the basis for their protest, and this Letter of Findings results.

DISCUSSION

I. Applicability of the Throw-Back Rule – Adjusted Gross Income Tax.

Taxpayer manufacturing division argues that the Department erred when it "threw back" the Illinois sales to Indiana. Taxpayer argues that the decision was inappropriate because it was subject to income tax in Illinois.

The audit determined that, for purposes of calculating taxpayer's Indiana tax liability, sales of auto parts to Illinois should be thrown back to Indiana because the sales were made within a state where taxpayer (the Indiana manufacturing division) was not subject to the state's income tax. The audit arrived at this conclusion because taxpayer did not have an Illinois situs, Illinois property, Illinois payroll, or an Illinois nexus. The audit found that taxpayer's only Illinois in-state activity was "sporadic."

The audit found authority for its decision to throw back the Illinois sales in 45 IAC 3.1-1-53(5) which states that "[i]f the taxpayer is not taxable in the state of the purchaser, the sale is attributed to [Indiana] if the property is shipped from an office, store, warehouse, factory, or other place of storage in this state." These sales are called "throw-back" sales. Id.

The underlying rule is found at IC 6-3-2-2. IC 6-3-2-2(e) provides that "[s]ales of tangible personal property are in this state if . . . (2) the property is shipped from an office, a store, a warehouse, a factory, or other place of storage in this state and . . . (B) the taxpayer is not taxable in the state of the purchaser." IC 6-3-2-2(n) provides that "[f]or purposes of allocation and apportionment of income . . . a taxpayer is taxable in another state if: (1) in that state the taxpayer is subject to a net income tax, a franchise tax measured by net income, a franchise tax for the privilege of doing business or a corporate stock tax; or (2) that state has jurisdiction to subject the taxpayer to a net income tax regardless of whether, in fact the state does or does not." Accordingly, in order to properly allocate income to a foreign state, taxpayer must show that one of the taxes listed in IC 6-3-2-2(n)(1) has been levied against him or that the state has the jurisdiction to impose a net income tax regardless of "whether, in fact, the state does or does not." Id.

Therefore, in order to avoid having the Illinois sales receipts thrown back to Indiana, the taxpayer must show its Illinois activities are such that it was brought within the orbit of the Illinois tax scheme. In support of the proposition that the sales should be thrown back to Indiana, the audit report noted that taxpayer did not pay Illinois income tax during 1996 and 1997 and that it had not filed Illinois returns during that period. In addition, the audit reported that taxpayer

did not maintain an Illinois business location, did not have property within Illinois, and did not have payroll attributable to Illinois.

The fact that taxpayer did not pay Illinois income tax during this period and – in fact – did not even file Illinois returns is useful in resolving the throw-back issue, but it is not determinative. Instead, whether or not Indiana can throw back these sales hinges on whether or not "taxpayer's business activities are sufficient to give the state jurisdiction to impose a net income tax under the Constitution and statutes of the United States." 45 IAC 3.1-1-64.

15 U.S.C.S. § 381 (Public Law 86-272) controls those occasions in which a state – such as Illinois – can impose a tax on the net income, derived from sources within that state, received by foreign (out-of-state) taxpayers. 15 U.S.C.S. § 381 sets a minimum standard for the imposition of a state income based on the solicitation of interstate sales. Wisconsin Dept. of Revenue v. William Wrigley, Jr., Co., 112 S.Ct. 2447, 2453 (1992). 15 U.S.C.S. § 381 prohibits Illinois from imposing its net income tax on taxpayer if taxpayer's only business activity within that state is the solicitation of sales. Illinois may impose its net income tax on income received from an out-of-state entity's business activities unless those business activities exceed the mere solicitation of sales. Conversely, the effect of Indiana's throw-back rule is to revert this sales income back to Indiana in those situations where 15 U.S.C.S. § 381 deprives the purchaser's own state of the authority to impose a net income tax. 45 IAC 3.1-1-64. In effect, 15 U.S.C.S. § 381 allows Indiana to tax out-of-state business activities, without violating the Commerce Clause and without subjecting taxpayer to double taxation, because Indiana's right to tax those out-of-state activities is derivative of the foreign state's own taxing authority. In every sales transaction, at least one state has the power to tax income derived from the sale of tangible personal property; if the state wherein the sale occurred is forbidden to do so by 15 U.S.C.S. § 381, then that income is "thrown back" to the originating state.

The Department is unable to agree with taxpayer's conclusion that its Illinois activities subjected it to the Illinois net income tax during 1996 and 1997. During that period, taxpayer's only Illinois activity – aside from soliciting sales of its auto parts – consisted of sending one or two employees "on a sporadic basis" to inspect nonconforming auto parts at the Illinois customer's location. This would appear to be the extent of taxpayer's non-solicitation Illinois activity; if Illinois customer complained that one of taxpayer's auto parts did not conform to the customer's original specification, taxpayer would send one (or two) of its Indiana employees to examine that part. Even if it is possible to separate these inspections from the solicitation of the original sale, these investigative activities plainly fall within the de minimis exception described by the Court in Wrigley. As explained by the Court, "[A] company does not necessarily forfeit its tax immunity under § 381 by performing *some* in-state business activities go beyond 'solicitation of orders.'" Wrigley 112 S.Ct. at 2457. (*Emphasis in original*). Taxpayer's sporadic inspection of non-conforming parts "is sufficiently *de minimis* to avoid loss of the tax immunity conferred by § 381." Id. at 2458. The inspection of the auto parts did not void the immunity from Illinois income taxes conferred under 15 U.S.C.S. § 381 and Illinois may not tax these particular receipts. Accordingly, the audit was correct in concluding that the income received from the Illinois sales should have been thrown back to Indiana.

FINDING

Taxpayer's protest is respectfully denied.

II. Management Fees and Royalty Payments as Indiana Source Income – Adjusted Gross Income Tax.

Taxpayer parent company (Michigan) and taxpayer manufacturing division (Indiana) had an arrangement by which taxpayer manufacturing division paid money to taxpayer parent company. Taxpayer parent company provided taxpayer manufacturing division with "patented proprietary technology," "ancillary technical services," the right to use taxpayer parent company's trade name, and the right to use proprietary "just in time computer technology." In return, taxpayer manufacturing division agreed to manufacture auto parts which met taxpayer parent company's standards for quality of materials, procedures, and manufacturing methods. Taxpayer manufacturing division agreed to pay taxpayer parent company a five percent royalty fee based on the invoice price of the auto parts.

Taxpayer parent company also provided management services to taxpayer manufacturing division. Taxpayer parent company's personnel visited the Indiana facility, provided engineering services, research and development services, and provided various management functions. In return, taxpayer manufacturing division paid taxpayer parent company a "management fee."

The audit review concluded that taxpayer parent company should have been paying Indiana adjusted gross and supplemental net income tax on the royalties and management fees. Taxpayer – in the most general of terms – disagrees.

IC 6-3-2-1 imposes a tax on the adjusted gross income derived from "sources within Indiana." IC 6-3-2-2(a) provides that adjusted gross income derived from sources within Indiana includes "income from doing business in this state." IC 6-3-2-2(a). 45 IAC 3.1-1-38, in interpreting IC 6-3-2-2(a), provides that for apportionment purposes a taxpayer is "doing business" in Indiana if it operates a business enterprise or activity in Indiana including "[r]endering services to customers in the state." 45 IAC 3.1-1-38(4).

Taxpayer parent company entered into an agreement by which it provided management and other services to taxpayer manufacturing division. Taxpayer sent its employees into the state to provide these services. Therefore, the management fees taxpayer manufacturing division paid to taxpayer parent company constitute "income from doing business in this state." IC 6-3-2-2(a). Taxpayer parent company was providing services to its manufacturing division, and the resultant income is subject to the state's adjusted gross income tax.

In addition, taxpayer parent company received royalty payments from taxpayer manufacturing division. These royalty payments resulted when taxpayer parent company licensed its trademark rights to taxpayer manufacturing division; in return for the right to use the trademarks, taxpayer manufacturing division paid five percent of the sales of its branded auto parts to taxpayer parent company.

In order for Indiana to tax the money received from an intangible – such as taxpayer parent company's trademarks – the intangible must have acquired a "business situs" within the state. 45 IAC 3.1-1-55 states that "[t]he situs of intangible personal property is the commercial domicile of the taxpayer . . . unless the property has acquired a 'business situs' elsewhere. 'Business situs' is the place at which the intangible personal property is employed as capital; or the place where the property is located if possession and control of the property is localized in connection with a trade or business so that substantial use or value attaches to the property."

Taxpayer parent company's commercial domicile is in Michigan. However, it is clear from the arrangement between taxpayer parent company and taxpayer manufacturing division, that the intellectual property has acquired a "business situs" within Indiana. Taxpayer parent company has licensed to taxpayer manufacturing division to make use of the trademarks within Indiana in conjunction with the manufacture and sale of taxpayer manufacturing division's auto parts. The "substantial use or value" which attaches to these particular trademark rights is inherent in the ability to transfer the trademarks for use at the Indiana manufacturing facility. The royalty payments here at issue are merely the economic benefits which flow from the fact that taxpayer manufacturing division exploits the trademarks' value within Indiana. Under 45 IAC 3.1-1-55, the trademarks have acquired an Indiana business situs; under IC 6-3-2-2(a), the royalty payments are subject to Indiana's adjusted gross income tax.

FINDING

Taxpayer's protest is respectfully denied.

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